Supreme Court, U.S.
FILED
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NO. _____

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1994

INVEX HOLDINGS, N.V., PETITIONER

V.

EQUITABLE LIFE INSURANCE COMPANY OF IOWA, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI
TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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September 8, 1994

27 pp

QUESTIONS PRESENTED

I. Whether the interest to be awarded an oversecured creditor on its claim under §506(b) of the Bankruptcy Code should be determined by the default rate set forth in the underlying agreement between the creditor and the debtor.

II. Accepting that a default rate of interest is intended to compensate a creditor for additional fees, costs, and charges incurred as a result of a debtor's default, whether, under §506(b), an oversecured creditor is entitled to interest on its claim at the default rate set forth in the underlying agreement with the debtor when the creditor has already been awarded the actual fees, costs, and charges provided for in that agreement.

RULE 29.1 LISTING

Pursuant to Rule 29.1 of the Rules of this Court, the Petitioner, Invex Holdings, N.V., states that it has no parent company and no subsidiaries other than wholly owned subsidiaries.

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EQUITABLE LIFE INSURANCE COMPANY OF IOWA, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Invex Holdings, N.V. respectfully petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., infra, 1-17) is reported at 27 F.3d 241. The opinions of the district court (App., infra, 18-42; and the bankruptcy court (App., infra, 45-69) are currently unreported.

JURISDICTION

The court of appeals entered its judgment on June 10, 1994 (App., infra, 1). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

Section 506(b) of the United States Bankruptcy Code provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be

allowed to the holder of such claim interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

11 U.S.C. §506(b).

STATEMENT OF THE CASE

This petition seeks the review of the judgment of the United States Court of Appeals for the Seventh Circuit entered on June 10, 1994 effectively denying the Objection of Invex Holdings, N.V. to the Secured Claim of Equitable Life Insurance Company of Iowa.

The jurisdiction of the court of appeals was invoked under 28 U.S.C. §158(d) upon the timely notice of appeal of the judgment entered by the United States District Court for the Northern District of Indiana which affirmed the

decision of the United States Bankruptcy Court for the Northern District of Indiana. The bankruptcy court's jurisdiction was invoked under 28 U.S.C. §157, and the district court's jurisdiction was invoked under 28 U.S.C. §158(a).

In December 1983, Terry Limited Partnership acquired the beneficial interest in the leasehold estate of commercial property in South Bend, Indiana known as the Society Bank Building. The beneficial interest was purchased from Invex Finance, B.V. for $5,700,000.00. The beneficial interest was subject to a first mortgage ultimately held by Roosevelt Savings Bank, a second mortgage ultimately held by Equitable Life Insurance Company of Iowa (hereinafter referred to as "Equitable"), a third mortgage held by

Invex Holdings, N.V. (hereinafter referred to as "Invex"), and a fourth mortgage held by Invex Finance, B.V. The third and fourth mortgages were wraparound mortgages which meant that as Terry Limited Partnership made payments toward the first and second mortgages, the balances owed on the third and fourth mortgages decreased.

The second mortgage held by Equitable secured a $2,100,000.00 promissory note and accrued contract interest at the rate of 14¼% per annum. However, upon Terry Limited Partnership's default, interest would accrue at the rate of 17¼% per annum. The third mortgage held by Invex secured a $5,171,000.00 wraparound promissory note and accrued interest at the rate of 17¼% per annum. Invex's note was subject to deferred interest which meant that Invex

would realize no gain unless Terry Limited Partnership made all payments required under superior notes and mortgages.

By April 1990, Terry Limited Partnership had fallen behind on its obligations under the respective notes and mortgages. Consequently, on April 27, 1990, Invex filed an Involuntary Chapter 11 Petition for Relief against Terry Limited Partnership. An Order for Relief under Chapter 11 was entered by the bankruptcy court on June 12, 1990. On November 22, 1991, the bankruptcy court determined that the debtor's interest in the Society Bank Building had a value of $5,350,000.00, rendering Equitable's claim oversecured, and Invex's claim undersecured.

By September 23, 1992, Terry Limited Partnership had yet to have a plan of

reorganization approved by the bankruptcy court. Accordingly, the bankruptcy court ordered the debtor's interest in the Society Bank Building sold pursuant to 11 U.S.C. §363. Prior to the sale of the property, however, Invex filed its Objection to the Secured Claim of Equitable Life Insurance Company of Iowa asserting that Equitable was not entitled to receive postpetition interest on its claim at the default rate of 17¼%.

Pursuant to the bankruptcy court's order, the debtor's interest in the Society Bank Building was sold at public auction. Invex was the successful bidder and purchased the property for $4,005,001.00. Out of these proceeds, the first mortgage held by Roosevelt Savings Bank was paid in full. Equitable was paid the outstanding principle due on its note, accrued interest at 14¼%, plus

fees and expenses incurred and itemized by Equitable. $170,800.00 of the proceeds, representing the difference between interest on Equitable's claim at the default rate of 17¼% and the base contract rate of 14¼%, were held in escrow by the debtor pending a ruling by the bankruptcy court on Invex's objection to Equitable's claim.

Prior to its ruling, the bankruptcy court heard evidence pertaining to the reasonableness of Equitable's default rate. Of particular import was the testimony of Invex's own expert witness. That testimony revealed that primarily a default rate of interest is to coerce prompt payment from a debtor. Thereafter, a default rate of interest is designed to compensate a creditor for the additional costs incurred as a result of a debtor's default. This testimony

further revealed that the 17¼% default rate agreed to by the debtor and Equitable was not unreasonable at the time of the original loan transaction. However, that rate was unreasonably high compared to prevailing market rates for similar properties at the time of the debtor's default and at the time of the Order for Relief under Chapter 11. No evidence was presented intimating that any of the fees, costs, or other charges associated with the debtor's default on the Equitable note remained unpaid. Further, no evidence was presented indicated that the 17¼% base interest rate on the undersecured, third priority Invex note was unreasonable at any time.

On March 31, 1993, the bankruptcy court entered judgment denying Invex's objection to Equitable's claim. Central to the bankruptcy court's decision was

the fact that Equitable's default rate of interest was not unreasonable at the time of the original loan transaction. The court also found that the equities of the case did not justify altering the rate agreed upon by the debtor and Equitable because, the court opined, to do so would augment the rights bargained for by Invex.

In addition, the bankruptcy court found that the default rate of interest did not overcompensate Equitable for its post-default costs. According to the court, the default rate was reasonable because it was intended to compensate for increased expenses in administering the loan and no exactitude in the amounts actually expended needed to be considered.

On appeal, the United States District Court for the Northern District

of Indiana affirmed and similarly noted that equity did not require the displacement of the default rate of interest when the interest rate's spread over and above the contract rate was within the range normally charged by lenders, and the default rate was reasonable at the time of the original transaction.

The district court further noted that the default rate did not overcompensate Equitable for its post-default administrative costs even though there was no evidence of unpaid post default expenses. According to the court, no laundry list of expenses is necessary as the agreement was bargained for by the debtor and Equitable.

On June 10, 1994, the United States Court of Appeals for the Seventh Circuit entered judgment affirming the decision

of the district court and the bankruptcy court. As with the lower courts, the appellate court found the 17¼% default rate to be reasonable in light of the prevailing market rates at the time of the original loan transaction.

The court of appeals also found that the default rate did not overcompensate Equitable. The court recognized that Equitable received appraisal fees and attorney's fees in accordance with its note. The note, however, did not compensate Equitable for "unforeseeable costs" associated with the debtor's default. Noting that there is a difference between foreseeable and unforeseeable cost of a default, the court held that the default rate was designed to protect Equitable against unforeseeable consequences of a default and did not amount to a double recovery

of the fees, costs and charges incurred by Equitable.

Invex now submits this matter for review.

REASONS FOR GRANTING WRIT OF CERTIORARI

Invex submits that this case presents an important question of federal law which has not, but should be, settled by this Court; namely, what is "interest" under §506(b) of the United States Bankruptcy Code.

In United States v. Ron Pair Enterprises, 489 U.S. 235 (1989), this Court ruled that under §506(b), interest on an oversecured claim is unqualified and that it applied to nonconsensual as well as consensual secured interests. 489 U.S. at 245-246. In so holding, this Court held that under §506(b), "interest on such claim" is not joined with "fees,

costs, or charges" and it is not modified by or related to the "provided for under the agreement" clause of that section. 489 U.S. 241-242. In short, this Court held that interest is not tied to any agreement. However, the court left unanswered, what "interest" is under §506(b).

"Interest" has been defined as the "[b]asic cost of borrowing money or borrowing on installment contract. Payments a borrower pays a lender for the use of money." Blacks Law Dictionary, 5th Ed. (West 1979). Despite such a definition, and despite this Court's ruling in Ron Pair that "interest" is distinct from "fees, costs, and charges," lower courts continue to include amounts in secured claims which do not represent the cost of money.

To a large extent, lower courts have interpreted "interest" under §506(b) as meaning the rate provided for in the underlying agreement between the debtor and creditor unless "the higher rate would produce an inequitable or unconscionable result, so as to require disallowance thereof." In re Laymon, 958 F.2d 72, 75 (5th Cir. 1992) cert. denied sub. nom. Crozier v. Bradford, _____ U.S., _____, 121 L.Ed.2d 247; In re Courtland Estates Corp., 144 B.R. 5 (Bankr. D. Mass. 1992); Matter of Gladdin, 107 B.R. 803 (Bankr. D. Ga. 1989).

Some of these courts are quite rigid in holding that §506(b) specifically means contract rate interest. Matter of Glenn, 796 F.2d 1144, 1147 (9th Cir. 1986) but see Landmark Financial Services v. Hull, 918 F.2d 1150 (4th Cir. 1990)

(interest on consensual liens awarded without contract provision). Matter of 268 LTD., 789 F.2d 674 (9th Cir. 1986).

Other courts recognize this Court's pre-Code pronouncement that "it is manifest that the touchstone of each such decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditor and the debtor." Vanston Bondholders Protection Committee v. Green, 329 U.S. 156, 165 (1946). See In re W.S. Sheppley & Co., 62 B.R. 271 (Bankr. N.D. Iowa 1986); In re D.W.S. Investments, Inc., 121 B.R. 845 (Bankr. C.D. Cal. 1990); In re Schaumburg Hotel Owner Limited Partnership, 97 B.R. 943 (Bankr. N.D. Ill. 1989). It is the latter group of courts which flexibly applies various equitable principles to

determine whether a default rate of interest is reasonable and should be applied to an oversecured claim. For example, in Sheppley, supra, the court devised a five part analysis based upon the secured creditor's risk of nonpayment, prevailing market rate, speed of reorganization, and ultimate distribution to shareholders. Others look at whether there is a justification for the enhanced default rate. In re Hollstrom, 133 B.R. 535 (Bankr. D. Colo. 1991). Still others look at whether the default rate is in keeping with current market rates. In re Laza, 69 B.R. 669 (Bankr. E.D. N.Y. 1987).

Seldom, however, is the analysis ever based upon whether the "interest" sought is actually "interest" or some other form of compensation, real or theoretical, resulting from the debtor's

default. In In re Consolidated Properties, 152 B.R. 452 (Bankr. Md. 1993), the bankruptcy court noted the distinction between what is actually "interest" and other forms of compensation:

> A default rate of interest that reflects a reasonable attempt to compensate a creditor for extra costs incurred after default is more in the nature of additional "fees, costs, or charges provided for under the agreement" than mere "interest on such claim", which is not tied to an underlying agreement by §506(b). Section 506(b) allows postpetition interest on the claims of oversecured creditors; however it does not state that oversecured creditors are automatically entitled to a bargained for rate of interest without limit. An increase in the rate of interest upon default may either be a coercive penalty or a bargained for attempt to compensate a creditor for its extra costs after default. If it is a penalty, it would inequitable to allow its impact to fall on other creditors or to allow it to destroy a debtor's opportunity to reorganize."

152 B.R. at 455.

This Court went to great lengths in Ron Pair to indicate that "interest" is not tied to "fees, costs, or charges" or to any underlying "agreement." Consolidated Properties appropriately focuses the inquiry on whether an agreed upon default rate is actually "interest." However, absent a ruling by this Court as to what constitutes "interest" under §506(b), lower courts will continue to apply analyses ranging from strict adherence to the underlying agreements between debtors and creditors to the various application of equitable principles of reasonableness and unconscionability without consistent determinations of whether the particular default rate interest is actually interest or some other cost.

The Seventh Circuit's decision in this case typifies the need for a

pronouncement that interest is interest and costs are costs. According to the court of appeals:

> Equitable's note entitled to receive appraisal fees and attorney's fees. This provision fails, however, to compensate Equitable for the unforeseeable costs associated with Terry's default. As Schefmeyer's testimony bears out, a default situation requires a creditor to actively monitor the collateral to ensure that its value is preserved. The costs incurred in performing this task very from case to case and simply cannot be provided for beforehand. Inclusion of a default rate of interest is designed to address this difficulty. [Citation omitted]. Recognizing the distinction between the foreseeable and unforeseeable costs of a default, the bankruptcy court correctly determined that the default rate was designed to compensate for losses suffered in addition to those provided for in the agreement.
>
> (App., 14).

The court of appeals viewed the default rate of interest here as being intended to compensate for "unforeseeable costs." "Interest", however, is the cost

of using money, not unforeseeable costs of default. The failure of the Seventh Circuit to make the distinction between the two blurs the demarcation between interest and costs found by this Court to exist under §506(b). The result is that Equitable has been awarded not only its actual costs incurred as a result of the debtor's default, but also undocumented, unforeseeable, and otherwise hypothesized costs labeled as "interest."

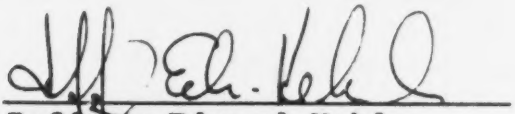
The Seventh Circuit decision is indicative of the adulteration by lower courts of the clear and unambiguous distinction between interest and costs as set forth in §506(b) of the Bankruptcy Code. Consequently, the meaning of "interest" under §506(b) has become an important federal question. This case provides the Court with the opportunity

to clarify that meaning and review should be granted for that purpose.

CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,



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